



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Number: **201108042**
Release Date: 2/25/2011

Date: December 2, 2010

UIL: 501.32-01; 501.33-00; 501.36-01

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

Dear :

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

Since you do not qualify for exemption as an organization described in Code section 501(c)(3), donors may not deduct contributions to you under Code section 170. You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, you should follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

In accordance with Code section 6104(c), we will notify the appropriate State officials of our determination by sending them a copy of this final letter and the proposed adverse letter. You should contact your State officials if you have any questions about how this determination may affect your State responsibilities and requirements.

Letter 4038(CG) (11-2005)
Catalog Number 47632S

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Robert Choi
Director, Exempt Organizations
Rulings & Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter



TAX EXEMPT AND
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DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: December 2, 2010

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend:

M = Name of Entity
B = Name of Individual
C = Name of Individual
G = Name of Entity
H = Name of Entity
O = Name of Borough
P = Name of Borough
Q = Name of Borough
R = Name of Borough
S = Name of Borough
X = Date
Y = Name of State
Z = Name of State

UIL Nos:

501.32.01
501.33.00
501.36.01

Dear :

We have considered your application for recognition of exemption from Federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

ISSUES

- a. Do you meet the organizational test for recognition of exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code? No, for the reasons described below.
- b. Do you operate to serve a substantial non-exempt commercial purpose in contravention of section 501(c)(3) of the Internal Revenue Code? Yes, for the reasons described below.
- c. Are you formed as a vehicle to obtain grants and charitable contributions for the benefit of B,

H, C and B's for-profit beauty salon business, resulting in inurement and/or impermissible private benefit? Yes, for the reasons described below.

- d. Have you met the burden of proof that you are operated exclusively for tax exempt purposes under section 501(c)(3) of the Internal Revenue Code? No, for the reasons described below.

FACTS

You, M, filed Form 1023 application requesting recognition of tax exemption under Section 501(c)(3) of the Internal Revenue Code. You were incorporated on X as a Y corporation that operates in Z. Your Articles of Incorporation do not limit your purpose to an exempt purpose under section 501(c)(3) of the Code. Your purpose according to your Articles of Incorporation is to be a nonprofit public benefit entity, not organized for the private gain of any person. Your Articles of Incorporation also do not contain a dissolution provision dedicating your assets to an exempt purpose under section 501(c)(3) of the Code. B is listed as your sole board member/director on your Articles of Incorporation. The registered agent listed on the Articles of Incorporation is G, an entity affiliated with H, which is a for-profit fundraising consulting firm. Article 9 of your Bylaws states that you will not issue shares of stock and that you are an entity without shareholders. However, other parts of your Bylaws including Article 2 and Article 6 state that you do have shareholders.

You are governed and managed by two related individuals, B and C, who are mother and son. Your application lists B as your Director/President/Treasurer. C is listed as your Secretary. You state that you will be managed exclusively by B and her son, C. **Your Business Plan describes you as entirely owned by B.** Under the header, **Personnel Plan**, on your Business Plan, you provide that **your owner is to receive compensation of approximately \$36,000 to \$44,000 each year. Your Bylaws indicate that your business and affairs will be managed under the direction of your Board of Directors.** Since your sole board member/director, B, receives compensation from you, we inquired about how you have insured that compensation to your board member/director was determined in an unbiased manner. You responded that "the member will determine the compensation for [the] individual person." You did not describe the authority of your members or provide specific information regarding your membership.

According to your description of activities, you will help the community in the following ways:

- Help and teach the youth the awareness of the use of the drugs. We also teach them how to set goals that can help them have a better future.
- Help the employed mothers to find babysitters which help creating jobs for the unemployed women that have family to take care of.
- Help the senior citizen and the elderly people with their needs and have a companion available for them when needed.
- Conduct different religious meeting for the youth to help develop them religiously. e.g. Bible Study Meeting, Youth Meeting. Priests will be invited to help conducting those types of meetings.
- Communicate with large and respectable firms that are in need for employers and send them the unemployed so we can help the unemployed find jobs.

- Develop Ads in the newspaper and the television to help the children that suffer from cancer with their needs.

You clarified in subsequent correspondence that your specific stated purpose is to operate a cosmetology training facility to enable high school and vocational school students to become hairdressers. Because it is not necessary to have a high school diploma in order to become a hairdresser, the cosmetology training offered by you will help students without a high school diploma attain a means of employment. Although your focus is on high school students, you do not limit your training program to a specific charitable class of individuals. Instead, you indicate that you will train any interested individual. You do not require any enrollment forms, set hours or age requirement to enroll in your job training program.

According to your Business Plan, B, has owned and operated a for-profit beauty salon for over 13 years. B will be handling all aspects of your job training program. Your receptionist will manage all of the appointments as well as the people who walk in, and be responsible for the point of sale transactions. You will also have four part-time hair stylist teachers. **Your employees all have long employment with B at the present shop.** "With the expansion for a new learning facility, the present employees will also offer their time and knowledge to assist B in training students." You have not provided specific information regarding the written materials or curriculum you use in your job training program. You do not have an established timeframe for students to complete the job training program. You state that students will be provided training four hours a day for a total of approximately 500 to 1,000 hours each. However, you also state that students may remain in your on-the-job training program for as long as they need. **After the cosmetology training is complete, B may hire the trained individuals as hair stylists in her own beauty salon or help them start their own hair salons.** Aside from possible employment in B's beauty salon and helping the students to start their own hair salon businesses, you have not provided information regarding the job placement program you have implemented to locate permanent employment for your graduates. Additionally, you provide that once the graduate is employed, monthly payments based on affordability will be arranged with the graduate to pay for the training that they previously received. This is done to keep a help fund available for other persons who cannot afford to pay.

Your beauty salon is open to the public. You will provide hair styling services for the entire family in exchange for a fee. This includes hair cuts for men and women, permanents and hair coloring for women, as well as hair cuts for children. Shampoo service will be offered for all adults. Service is offered on a walk-in basis or by appointment. You will sell hair care products which are forecasted to account for 15 percent of your sales. These professional-quality supplies will include shampoos, conditioners, reconstructors, brushes, combs, and other styling aids. Your beauty salon will have up-scale ambiance, quality cappuccino machines, a glass pastry display case to provide enticing refreshments, plush seating for comfort and state-of-the art equipment where customers can enjoy a beautiful flat-screen TV while receiving hair treatments.

You state that you will increase market share and expand your customer base by offering superior service. You recognize that the hair cutting/styling market is crowded so it is difficult to stand out. You face competition from the expansion of national discount stores into the local market. You state that the continued price pressure from competition will weaken contribution margins. You provide in your Business Plan that "There are many hair stylist training facilities like [you]; however, many of these facilities only provide the minimum training services, whereas the upscale training

facilities can be inconvenient due to scheduling requirements and cost. [Your owner, B,] perceives an unfulfilled customer need for a low-cost hair stylist training schools that provides maximum flexibility and strong customer attention. **Using this strategy, [you expect that you] will gain significant market share and create critical long-term relationships with [your] clients."**

You specify that you will advertise through flyers and brochures to be sent out with local newspapers as well as through your website. You state that your website will be a virtual business card and portfolio for the company, as well as its online "home." Your website will feature various hair styles and services you provide along with information on accessories that are sold in the salon. The website will provide interactive information on marketing materials, training programs and package offerings. You state that your owner will work with a website manager to continue developing a simple, classy, and focused website. Moreover, you will also have an in-store promotion for the first few months of operation to lure new people in. You will offer a discount for a few months to people that refer new customers and allow students to service their hair styling needs.

Additionally, you indicate on your Business Plan that **B will be using a partial commission basis to create incentives for superior customer attention for her four part-time stylists.** The more the stylists attend to the customer's needs, the more money they will make from commissions. You will invest time and money into training to ensure that clients receive the best experience possible, thereby making it easier to turn them into long-term customers.

Furthermore, you believe that it is possible to offer a differentiated service through improved customer service at no greater significant cost if the right employee incentives are provided. **With this strategy in mind, your goal is to increase the number of clients served by at least 20 percent per year by offering discounts if the customers allow students to take care of their hair styling needs.** You provide that your market segmentation will target all five boroughs (Q, P, Q, R, and S) throughout Z. Your first target area is P. Once established in this area, expansion into the other boroughs will follow.

Your budgets show the following projected income and expenses:

Income	20	20	20
Gift, grants and contributions	\$	\$	\$
Total Income			
Expenses			
Fundraising expenses			
Compensation of officers and directors		0	
Occupancy		0	
Professional fees		0	
Total Expenses	\$	\$	\$

You did not report any revenues from haircut services, product sales or training fees received on your budgets. In addition, other than compensation to officers and directors, you did not report any salaries for employees, including any salaries paid to your part-time hair stylists.

Your Business Plan, however, shows capital building expenses of \$, capital equipment expenses of \$, rental expense of \$ and utilities of \$ in your first year of operation. Also, vehicle maintenance and travel will account for \$ in your first year of operation. In addition, you project school books and materials to account for \$ to \$ of expenses per year in your operations over the next three years. Net surpluses are projected at \$ in your first year of operation, \$ in your second year of operation and \$ in your third year of operation.

You operate in the same facility as B's for-profit beauty salon. It appears that B rents the beauty salon facility from an unrelated party. There is also a dance studio on the premises. When we asked you to explain your occupancy expenses shown on the Form 1023 application and to submit a copy of your rental agreement, you provided a portion of the rental agreement that authorizes the beauty salon franchisee to assign the lease to another entity. You also apparently submitted a portion of the rental agreement that B's beauty salon has with an unrelated lessor. The annual rental fees are approximately \$ for the facility. Your facility is furnished, has seven stations and two shampoo sinks. Despite sharing your facility with B's for-profit beauty salon, you project to incur occupancy expenses of \$ per year as well of \$ for capital building expenses and \$ capital equipment expenses in your first year of operation.

You provide that H instigated the creation of your organization. **You state that H reached out to B by telephone and advised B to open a non-profit corporation for the benefit of receiving grants.** You provided a copy of a receipt showing that B paid \$ to H. You also submitted a copy of the contract B has with H dated August , 20 , which stipulates that H is to file the necessary legal documents to establish you as a non-profit corporation with the appropriate state officials, serve as your Resident Agent for one year, complete the Form 1023 application on your behalf, assist you with the Form 1023 determination process as well as provide you with counseling and guidance to show you how to operate your corporation. Based on the contract, another \$7,500 is to be paid to H upon receipt of a grant.

When asked about how the income and expenses on your budgets were determined, you indicated that H had made these estimates for you. When questioned about your reason for incorporating in the state of Y, you stated that H had done it for you. When asked about whether you are required to file any notices in the state of Z in order to operate in Z as a Y corporation, you indicated that you did not know and that it would be the job of your accountant to find out.

You held your initial board meeting on February , 20 . Your Chairman/President, B, submitted a bill for reimbursement of pre-incorporation costs incurred. Your Chairman/President, B, then proposed that officers and directors be reimbursed for all current and future corporation costs and expenses that they personally paid. It was resolved that the Treasurer, also B, is authorized and directed to reimburse officers and directors of the corporation for any and all costs and expenses advanced or incurred in the normal legal business operations of this corporation. Therefore, B expects that once you receive charitable contributions, you will reimburse her \$, which includes a \$ loan she made to you and \$ that she paid to H.

LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of corporations **organized and operated** exclusively for charitable, educational, and other exempt purposes, provided that **no part of the net earnings inure to the benefit of any private shareholder or individual**.

Section 1.501(a)-1(c) of the Income Tax Regulations provides that the words "**private shareholder or individual**" in **section 501** refer to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(a)(1) of the regulations provides that, in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. **If an organization fails to meet either the organizational test or the operational test, it is not exempt.**

Section 1.501(c)(3)-1(b)(1)(i) of the regulations provides that an organization is organized exclusively for one or more exempt purposes only if its articles of organization:

- (a) Limit the purposes of such organization to one or more exempt purposes; and
- (b) Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities that in themselves are not in furtherance of one or more exempt purposes.

Section 1.501(c)(3)-1(b)(4) of the regulations holds that an organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization's assets will be considered dedicated to an exempt purpose, for example, if, upon dissolution, such assets would, by reason of a provision in the organization's articles or operation of law, be distributed for one or more exempt purposes.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations **assigns the burden of proof to the applicant organization to show that it serves a public rather than a private interest** and specifically that it is not organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense and includes the relief of the poor and distressed or of the under privileged as well as the advancement of education.

Section 1.501(c)(3)-1(d)(3) of the regulations provides that the term "educational" refers to:

- (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or
- (b) The instruction of the public on subjects useful to the individual and beneficial to the community.

Section 1.501(c)(3)-1(e)(1) of the regulations provides that an organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business.

Revenue Ruling 73-127 held that an organization formed to operate a retail grocery store to sell food to residents of a poverty area at prices substantially lower than those charged by competing grocery stores and to provide job training for unemployed residents. The store's gross earnings were used principally to pay salaries and to expand the operations of the store. Only about four percent of the store's earnings were allocated for use in a continuous training program for the hard-core unemployed. **Some of the trainees became permanent employees at the grocery store.** Based on the facts of the case, the IRS concluded that the operation of the organization was **conducted on a scale larger than was reasonably necessary for the performance of the organization's training program.** Since the operation of the grocery store did not serve solely as a vehicle for carrying out the training program, exemption under IRC 501(c)(3) was denied.

Revenue Ruling 73-128 is a contrast to Revenue Ruling 73-127. Revenue Ruling 73-128, 1973-2 C.B. 222 described an organization formed to provide vocational training to unskilled persons unable to find employment. The organization's job training program centered on the manufacture and sale of a line of toy products. The program provided these unskilled persons with new skills through on-the-job training while they were earning a living. **Trainees were not hired as permanent employees** and the organization tried to place them in permanent positions in the community as soon as they were trained. More unskilled persons were then recruited as new trainees to continue the training process. **The Service noted that there was no evidence that the scale of the operation was such that it was being conducted on a larger scale than was reasonably necessary to accomplish the organization's charitable purpose.** Thus, it was held that the manufacturing activities were an integral part of the training process and therefore, an integral part of the organization's charitable program.

Revenue Ruling 76-91, 1976-1 C.B. 149, stated that where the purchaser is controlled by the seller or there is a close relationship between the two at the time of the sale, there can be no presumption that the purchase price represents fair market value because the elements of an arm's-length transaction are not present.

In Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will

destroy the exemption regardless of the number or importance of truly exempt purposes. The Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

The applicant for tax exempt status under section 501(c)(3) has the burden of showing it "comes squarely within the terms of the law conferring the benefit sought." Nelson v. Commissioner, 30 T.C. 1151, 1154 (1958).

Leon A. Beeghly Fund v. Commissioner, 35 T.C. 490 (1960) held that inurement occurred when organization entered a transaction to benefit the *stockholders* of a particular business corporation, not to benefit the charity, even though corporation suffered no financial loss. Where an exempt organization engages in a transaction with an insider and there is a *purpose* to benefit the insider rather than the organization, inurement occurs even though the transaction ultimately proves profitable for the exempt organization. ***The test is not ultimate profit or loss but whether, at every stage of the transaction, those controlling the organization guarded its interests and dealt with related parties at arm's-length.***

In Birmingham Business College, Inc. v. Commissioner, 276 F.2d 476 (5th Cir. 1960), the court denied tax exemption to an organization, in part because its net earnings were distributed to its shareholders for their personal benefit. **The founder of the organization and his two sisters were the only shareholders**; these three and two of their spouses were the organization's trustees. **The court found that the organization was operated as a business ultimately producing substantial revenues for its operators.**

For an organization claiming the benefits of section 501(c)(3), "exemption is a privilege, a matter of grace rather than right." Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849, 857 (10th Cir. 1972), cert. denied, 414 U.S. 864 (1973).

In Harding Hospital, Inc. v. United States, 505 F.2d 1068 (1974), the court held that **an organization seeking a ruling as to recognition of its tax exempt status has the burden of proving that it satisfies the requirements of the particular exemption statute.** Whether an organization has satisfied the operational test is a question of fact.

The petitioner in est of Hawaii, 71 T.C. 1067 (1979), conducted training, seminars and lectures in the area of intrapersonal awareness. Such activities were conducted under licensing arrangements with various for-profit corporations. The licensing agreements were conditioned on the petitioner maintaining tax exempt status. The petitioner argued that it had no commercial purpose of its own and that its payments to the for-profits were just ordinary and necessary business expenses. The Court did not agree.

To accede to petitioner's claim that it has no connection with International (the for-profit licensor of the educational program) is to ignore reality. While it may be true that the same individuals do not formally control them, International exerts considerable control over petitioner's activities. It sets the tuition for the standard training and requires a minimum number of such trainings. It requires petitioner to conduct regular seminars and to host special events. It controls the programs conducted by petitioner by providing trainers who are salaried by and responsible to est, Inc., and it further controls petitioner's operations by providing management

personnel who are paid by and responsible to est, Inc. In short, petitioner's only function is to present to the public for a fee ideas that are owned by International with materials and trainers that are supplied and controlled by est, Inc. Moreover, **we note that petitioner's rights vis-à-vis est, Inc., International, and PSMA are dependent on the existence of its tax-exempt status--an element that indicates the possibility, if not the likelihood, that the for-profit corporations were trading on such status...**

The question for the court was not whether the payments made to the for-profit were excessive, but whether it benefited substantially from the operation of the applicant. The court determined that there was a substantial private benefit because the applicant "was simply the instrument to subsidize the for-profit corporations and not vice versa and had no life independent of those corporations."

In P.L.L. Scholarship Fund v. Commissioner, 82 T.C. 196 (1984), an organization operated bingo at a bar (a for-profit enterprise) for purposes of raising money for scholarships. The board of directors included the bar's owners and accountant, and two other persons. The court reasoned that, because the bar owners controlled the organization and appointed its directors, the organization's fundraising activities could be used to the advantage of the bar owners, and thus, provide them with a maximum private benefit.

The organization claimed that it was independent because there was a separate accounting and that no payments were going to the bar. **The court maintained that the organization's and the bar's activities were so interrelated as to be "functionally inseparable."** A separate accounting did not change that fact. Thus, **the organization did not operate exclusively for exempt purposes, but rather benefited private interests – the bar owners.** Exemption was properly denied.

In Church by Mail, Inc. v. Commissioner, (1985) the Court affirmed a Tax Court decision. Church by Mail sent out sermons in numerous mailings. This required a great deal of printing services. A for-profit company, controlled by the same ministers, provided the printing and the mailing. This company also employed family members. The services were provided under two contracts. The contracts were signed by the two ministers for both the organization and the for-profit company. The organization's business comprised two-thirds of the overall business done by the for-profit company. The court determined that there was ample evidence in the record to support the finding that the organization was operated for the substantial non-exempt purpose of providing a market for the services of the for-profit company. The employees of the company spend two-thirds of their time working on the services provided to the church. The majority of the Church's income is paid to the for-profit company to cover repayments on loan principal, interest, and commissions. Finally, the potential for abuse created by the ministers' control of the Church requires open and candid disclosure of facts bearing upon the exemption application. Moreover, **the ministers' dual control of both the Church and the for-profit company enables them to profit from the affiliation of the two entities through increased compensation.**

In Easter House v. U.S., 12 Cl. Ct. 476 (1987), aff'd 846 F. 2d 78 (Fed. Cir 1988), the court found that adoption services were the primary activity of the organization. In deciding that the organization conducted adoption services for a business purpose rather for a charitable purpose, the court considered the manner in which the organization operated. The record

established a number of factors that characterize a commercial activity and which were evident in the operations of Easter House also. **The court determined that the organization competed with other commercial organizations providing similar services; fees were the only source of revenue; it accumulated very substantial profits, because it set its fees in order to generate a profit; the accumulated capital was substantially greater than the amounts spent on charitable and educational activity; and the organization did not solicit and did not plan to solicit contributions.** The court also found a corporate-type structure in the classes of memberships (including a single life member having inherent power that the holder could transfer like stock), and dependence on paid employees.

In International Postgraduate Medical foundation v. Commissioner, TCM 1989-36, the Tax Court concluded that **when a for-profit organization benefits substantially from the manner in which the activities of a related nonprofit organization were carried on, the latter organization was not operated exclusively for exempt purposes** within the meaning of section 501(c)(3), even if it furthers other exempt purposes.

In KJ's Fund Raisers, Inc. v. Commissioner, T.C. Memo 1997-424 (1997), affirmed 82 AFTR 2d 7092 (1998), the Tax Court found that a gaming organization was not exempt. While the organization raised money for charitable purposes, it also operated for the substantial benefit of private interests. The organization's founders, Kristine Hurd and James Gould, were the sole owners of a bar, KJ's Place. The organization, through the owners and employees of KJ's Place, sold lottery tickets exclusively at KJ's Place during regular business hours. While in KJ's Place, the lottery ticket purchasers were sold beverages. The initial directors were Hurd, Gould, and a related individual. The initial board was replaced several times until Hurd and Gould were no longer on the board. **At all times Hurd and Gould were the organization's officers. Salaries had been paid to Hurd and Gould and rent had been paid to KJ's Place.** The organization maintained that the fact that salaries and rent were no longer paid in this fashion indicated the independence of the board. The Court took another view: "Although those practices ceased and are not in issue here, the current board of directors is composed of at least the majority of the same members who allowed those amounts to be paid." **This strongly suggests that Hurd and Gould are free to set policy for their own benefit without objection from the board.** Nothing in the record since July 1, 1994, indicates otherwise.

In Salvation Navy v. Commissioner, T.C.M. 2002-275 (2002), the court found that one of the reasons why the organization did not qualify for exemption from federal income tax was because it could not prove that its net earnings would not inure to the benefit of a private individual, its founder.

In Airlie Foundation v. Commissioner, 283 F. Supp. 2d 58 (D.D.C., 2003), the court relied on the "commerciality" doctrine in applying the operational test. Because of the commercial manner in which this organization conducted its activities, the court found that it was operated for a non-exempt commercial purpose, rather than for a tax-exempt purpose. **"Among the major factors courts have considered in assessing commerciality are competition with for profit commercial entities; extent and degree of below cost services provided; pricing policies; and reasonableness of financial reserves. Additional factors include, *inter alia*, whether the organization uses commercial promotional methods (e.g. advertising) and the extent to which the organization receives charitable donations."**

The courts have repeatedly upheld the Service's determination that an organization has failed to establish exemption where the organization fails to provide requested information. "[Applicant] has, for the most part, provided only generalizations in response to repeated requests by [the Service] for more detail on prospective activities.... Such generalizations do not satisfy us that [the applicant] qualifies for the exemption." Peoples Prize v. Commissioner, T.C. Memo 2004-12 (2004).

New Dynamics Foundation v. United States, 70 Fed.Cl. 782 (2006), was an action for declaratory judgment that the petitioner brought to challenge the denial of its application for exempt status. The court found that the administrative record supported the Service's denial on the basis that the organization operated for the private benefit of its founder, who had a history of promoting dubious schemes. The organization's petition claimed that the founder had resigned and it had changed. However, there was little evidence of change other than replacement of the founder with an acquaintance who had no apparent qualifications. The court resolved these questions against the petitioner, who had the burden of establishing it was qualified for exemption. If the petitioner had evidence that contradicted these findings, it should have submitted it as part of the administrative process. "It is well-accepted that, in initial qualification cases such as this, gaps in the administrative record are resolved against the applicant."

Application of Law:

Based on our analysis of the information you submitted, we conclude that you do not satisfy the organizational and operational requirements of the Code and regulations to be recognized as exempt under section 501(c)(3) of the Code. The administrative record demonstrates that you operate for a substantial non-exempt commercial purpose rather than a charitable purpose in contravention of section 501(c)(3) of the Code. In addition, you have not established that your income will not inure to and/or serve the impermissible private benefit of your board member, B, your officer, C and your fundraising consultant, H. Furthermore, you have not met your burden of proof that you are formed exclusively for an exempt purpose under section 501(c)(3) of the Code.

Section 1.501(c)(3)-1(a)(1) of the regulations provides that, in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. **If an organization fails to meet either the organizational test or the operational test, it is not exempt.**

You do not meet the organizational test to qualify for recognition of tax exempt status under section 501(c)(3) of the Code. Your Articles of Incorporation do not limit your purpose to one or more exempt purposes as established in Section 1.501(c)(3)-1(b)(1)(i) of the regulations. Moreover, you fail the organizational test because your Articles of Incorporation do not dedicate your assets to an exempt purpose(s) under section 501(c)(3) of the Code as provided in section 1.501(c)(3)-1(b)(4) of the regulations.

We also hold that you do not satisfy the operational requirement to be recognized as exempt under section 501(c)(3) of the Code. You have not shown that you operate **exclusively** to educate individuals for the purpose of improving or developing their capabilities as provided in Section 1.501(c)(3)-1(d)(3) of the regulations. Although your stated purpose is to provide job training for individuals to become hairdressers, you have not demonstrated how your operation of a beauty salon is an integral part of a substantive job training program. You do not have a curriculum you

use on an on-going basis and have not provided any educational materials to show that you have an established educational methodology. Your job training program is not limited to the unemployed or underemployed. In addition, you charge a negotiated fee with each graduate once they are employed to cover the cost of the job training program that they previously received. You do not have an established timeframe upon which trainees are to graduate from your job training program. Your trainees are permitted to participate in your training program for as long as necessary. In other words, your program does not have a regular turnover of trainees, whereby one batch of trainees completes the training program and a new batch of trainees is recruited to continue the training process. In addition, although you state that B may offer your graduates permanent employment at her beauty salon or help them start a beauty salon of their own, you do not have a structured job placement program to locate employment for your graduates in the general workforce. **Moreover, you state that B paid H \$ to establish you as a non-profit corporation for the benefit of receiving grants.** Rather than being formed to serve the unemployed or to educate the public, you were created by your founders as a non-profit corporation to serve as a vehicle for the receipt of public funding. You do not appear to be operating a job training program for the purpose of public education.

Similar to the organization described in Revenue Ruling 73-127, some of your trainees will become permanent employees for B's for-profit beauty salon. Your earnings are also principally allocated to pay salaries (Compensation to directors/officers is the largest expenditure on your projected budgets.) and to expand your beauty salon operations across the five boroughs throughout Z. Based on these facts, your beauty salon appears to be conducted on a scale larger than is reasonably necessary for the performance of your training program. Your beauty salon appears, like the retail store described in Revenue Ruling 73-127, to serve more than as a vehicle to carry out a job training program.

Unlike that organization described in Revenue Ruling 73-128 that tried to place trainees in permanent positions in the community as soon as they were trained, you do not have a structured job placement program for your trainees. Your trainees may become permanent employees to staff B's beauty salon. Since your trainees may stay in your training program for as long as necessary, you do not have a regular turnover of trainees to continue the training process. Unlike the organization described in Revenue Ruling 73-128, your beauty salon appears to be conducted on a larger scale than is reasonably necessary to accomplish your stated job training purpose.

The administrative record demonstrates that you are operated for a substantial non-exempt commercial purpose, rather than a charitable purpose in contravention of section 501(c)(3) of the Code and section 1.501(c)(3)-1(c)(1) of the regulations. Your primary activity is the operation of a beauty salon that provides beauty care services in exchange for a fee. Your drive to grow your business is evident from your Business Plan which states that you intend to increase the number of clients served by at least 20 percent per year by offering discounts if the customers allow students to take care of their hair styling needs. You state your market segmentation will target all five boroughs (O, P, Q, R, and S) throughout Z. Your first target area will be P. Once established in this area, expansion into the other boroughs will follow. Like a commercial trade or business, your primary focus is in cultivating critical long-term relationships with your clients and expanding your client base. To expand your clientele, you will have in-store promotions for the first few months to lure new people in. You will offer a discount for a few months to people that refer new customers and allow students to service their hair styling needs. In addition, you indicate on your Business Plan that your stylists will be paid on a partial commission basis to create incentives for

superior customer attention. The more the stylists attend to the customer's needs, the more money they will make from commissions. You will invest time and money into training to ensure that clients receive the best experience possible making it easier to turn them into long-term customers. Your promotional methods and commission based incentive pay structure for your employees serve as evidence of your commercial motives. Analogous to the organization described in Better Business Bureau of Washington D.C., Inc. v. United States *supra*, your activities appear to have an underlying commercial motive that distinguishes your educational activities from that carried out by a university.

You meet the factors cited in Airlie Foundation v. Commissioner, *supra*, exemplifying a commercial operation. You have not demonstrated that you are responsive to the needs of the community. You have not shown that you receive referrals from or recruit unemployed individuals through public agencies or community groups as part of your job training program. You are controlled and operated by a single board member, B. Her son, C, serves as your only other officer. You do not have oversight by disinterested community members in your day-to-day operations. Your fundraising program consists of contracting with a fundraising consultant, H, to submit funding proposals on your behalf to corporations and foundations. You have not submitted any information which illustrates that you are currently receiving public donations. Although you did not specify the amount of revenues you will receive from the hair salon services, your services are rendered in exchange for fees. In fact, other than as temporary promotional offerings, you have not indicated that you will charge any price other than market price for the services offered at your beauty salon. Furthermore, like a for-profit business, you will allocate funds for advertising to increase your market share. You will advertise through flyers and brochures to be distributed with local newspapers as well as through your website. Your website will feature the various types of hair styles and services along with information on accessories that are sold in the salon. Through your website, clients may view marketing materials, training programs and package offerings. You advertise your salon services aggressively without much reference to a charitable purpose. Therefore, you have met many of the factors cited in Airlie Foundation v. Commissioner, *supra*, demonstrating a commercial manner of operation.

Like the organization described in Easter House v. U.S., *supra*, you are operated for a substantial business purpose rather than a charitable purpose. Analogous to the organization described in Easter House v. U.S., *supra*, your beauty salon operates in direct competition with other for-profit beauty salons. You recognize that the hair cutting/styling market is crowded so it is difficult to stand out. You face competition from the expansion of national discount stores into the local market. Similar to a for-profit beauty salon, you will provide hair styling services for the entire family in exchange for a fee. This includes hair cuts for men and women, permanents and hair coloring for women, as well as hair cuts for children. You will sell hair care products which are forecasted to account for 15 percent of your sales. Like a trade of business, you seek to improve customer satisfaction and to set yourself apart from the competition. Your beauty salon will have up-scale ambiance, quality cappuccino machines, plush seating for comfort and state-of-the art equipment where customers can enjoy a beautiful flat-screen TV while receiving hair treatments. Your fees are set high enough to generate a profit. Your projected accumulated capital is substantially greater than the amounts spent on any educational activity. Therefore, your manner of operation meets a number of factors that characterize a commercial activity.

Section 501(c)(3) of the Code and section 1.501(c)(3)-1(c)(2) of the regulations provide that no part of the net earnings may inure to the benefit of any private shareholder or individual. The

prohibition of inurement means that a private individual cannot pocket the organization's funds except as reasonable payment for goods or services. Prohibited inurement refers to transactions between a tax-exempt organization and an individual who can be considered an "insider." The private individual (insider) to whom the benefit inures has the ability to control or otherwise influence the actions of the tax-exempt organization so as to cause the benefit. As a general rule, an insider is referred to as an organization's trustee, officer, member, founder, or contributor.

You have not shown that your organizational structure and manner of operation do not result in inurement to B and C and B's related for-profit beauty salon business in the form of compensation, financing through public donations and an increase in beauty salon sales revenue. Your Bylaws state that your affairs are managed by your Board of Directors. B serves as your sole director. B's son, C, is the only other officer. On your Business Plan, you are described as entirely owned by B. This suggests that B has exclusive rights and control over you as well as the economic benefits generated by you. Despite this lack of independent oversight, you will compensate B approximately \$ to \$ per year. Compensation paid to your director does not appear to be made in an unbiased manner. Since B is your sole board member, it appears that she has determined her own compensation. You are using the same leased facility occupied by B's beauty salon. Nevertheless, you anticipate incurring occupancy expenses of \$ each year and on your Business Plan, you project capital building expenses of \$ and capital equipment expenses of \$ for your first year of operation. Revenue Ruling 76-91 explains that the presumption of an arm's-length arrangement is negated when the seller controls the purchaser. With respect to the compensation payments and rental transactions you have with B, the presumption of arm's-length arrangements is negated as the parties to the transactions are not disinterested.

Akin to the organization described in KJ's Fund Raisers, Inc. v. Commissioner, *supra*, your sole director is free to set policy for her own benefit without objection from disinterested members of the community. A substantial portion of your income will be returned to your board member B and/or her son, C, in the form of compensation, lease payments or other payments to B's for-profit beauty salon business. Due to a lack of oversight in your organizational structure, incidents of conflict of interest are not addressed. For example, according to your board meeting minutes, B, acting as your Chairman, submitted a bill for reimbursement. B, as your sole board member, voted that officers and directors be reimbursed for all current and future corporation costs and expenses that they personally paid. Your Treasurer, also B, is now authorized and directed to reimburse officers and directors of the corporation for any and all costs and expenses advanced or incurred in the normal legal business operations of the corporation. Thus, it appears that B, acting alone, has made the decision that you are to reimburse her for a \$ loan as well as a \$ payment she made to H. You resemble the organization described in Birmingham Business College, Inc. v. Commissioner and Salvation Navy v. Commissioner, *supra*, in that you have not proved that your net earnings would not inure to the benefit of private individuals, your board member and officer. Hence, it appears that a substantial purpose of your organization is to serve the private benefit of B and C and B's beauty salon business, resulting in prohibited inurement under section 501(c)(3) of the Code.

Furthermore, there does not appear to be a clear separation between your operations and those of the for-profit beauty salon owned by B. You and B's for-profit beauty salon provide virtually indistinguishable hair styling and beauty care services. You both operate in the same facility. You and B's beauty salon share common employees. Additionally, you state that, like B's for-profit

beauty salon, you are owned and operated by B. Since you do not report any sales revenues from hair care services and sales of hair care products on your financial information, it is unclear if the sales revenues are reported on the financial statements of B's beauty salon business instead. Although you claim that B's beauty salon is an independent for-profit entity, your operations are comparable to the organization described in P.L.L. Scholarship Fund v. Commissioner, supra, in that your activities and those of B's for-profit beauty salon, are so interrelated as to be functionally inseparable. Similar to the organization described in Church by Mail, supra, the dual control of your organization and B's for-profit beauty salon enables B to profit from the affiliation of the entities such as through increased compensation, financing through receipt of tax deductible contributions, and payment of rental expenses. You are operated as a trade or business ultimately producing substantial revenues for your operators, B and C. Like the organization described in International Postgraduate Medical Foundation v. Commissioner, supra, B's beauty salon benefits substantially from the manner in which the activities of your organization are carried on. Therefore, you are not operated *exclusively* for exempt purposes within the meaning of section 501(c)(3) of the Code.

A fundamental requirement for an organization that seeks exemption from federal income taxes is that it benefits the public rather than its creator, shareholders, or persons having a personal or private interest in the activities of the organization. (See section 1.501(c)(3)-1(d)(1)(ii) of the regulations.)

You have not shown that are not formed to serve the impermissible private benefit of H, a for-profit fundraising consulting firm. B and H both had a role in your creation and are deemed founders. **You state that H instigated the creation of your organization.** You provide that H reached out to B by telephone and advised her to open a non-profit corporation for the benefit of receiving grants. Thus, the idea to create your organization originated from H, a fundraising consultant. When asked about how the income and expenses on your budgets were determined, you indicated that H had made these estimates for you. When questioned about your reason for incorporating in the state of Y, you stated that H had done it for you. Under the consulting agreement, H is to advise you on the operation of your corporation. It appears that H, one of your founders, asserts significant control over your operations. The reason for your creation as a non-profit entity was to enable you to function as a means of obtaining public financing for B and H. B has already paid H \$5,000 to establish you as a non-profit entity. Through the service agreement, H is expected to continue to receive service fees from you for financial and fundraising services. Specifically, under the consultation agreement, H is to file the necessary legal documents to establish you as a non-profit corporation with the appropriate state officials, serve as your Resident Agent for one year, complete the Form 1023 application on your behalf, assist you with the Form 1023 determination process, provide you with counseling and guidance to show you how to operate your corporation and to fundraise on your behalf. G, a company associated with H, is your registered agent on your Articles of Incorporation. Upon receipt of funding, H is also to be paid an additional sum of \$. It appears that you intend to continue your relationship with H into the future. Your budgets show professional fees projected at \$ per year. You have not provided any evidence that your agreement and relationship with H has been discontinued. You were created for the purpose of providing a funding stream not only for B and her for-profit salon business, but also as a continued revenue source for the for-profit consulting firm H. Contrary to section 1.501(c)(3)-1(d)(1)(ii) of the regulations, you were formed to service a private, rather than, a public interest.

Leon A. Beeghly Fund v. Commissioner, supra, held that where an exempt organization engages

in a transaction with an insider and there is a *purpose* to benefit the insider rather than the organization, inurement occurs even though the transaction ultimately proves profitable for the exempt organization. ***The test is not ultimate profit or loss but whether, at every stage of the transaction, those controlling the organization guarded its interests and dealt with related parties at arm's-length.*** Analogous to the organization described in Leon A. Beeghly Fund v. Commissioner, *supra*, the purpose of your formation appears to be for the financial gain of B and H. Prohibited inurement and/or impermissible private benefit occur even if your transactions with the for-profit entity, H, do not produce a loss for you. Like the organization described in est of Hawaii v. Commissioner, *supra*, you are essentially established as a recipient for charitable funds to enable B and H to trade on your status as a non-profit organization. The benefits derived from your contractual arrangement constitute impermissible private benefit and/or inurement to H, which precludes your qualification for recognition of tax exemption under section 501(c)(3) of the Code.

Finally, you have failed to describe your job training program and manner of operation in sufficient detail to show that you are furthering an exclusively educational and or charitable purpose. As described in Peoples Prize v. Commissioner, Harding Hospital, Inc. v. United States, Nelson v. Commissioner, Christian Echoes National Ministry, Inc. v. United States, and New Dynamics Foundation v. United States, *supra*, the burden is on the applicant organization to demonstrate that it has met the operational test as specified under section 501(c)(3) of the Code. You have not shown that the operation of your beauty salon is an integral part of a substantive educational job training program. Your primary goal appears to be devoted to the expansion of your beauty salon operations throughout the boroughs of Z, thereby furthering a substantial non-exempt commercial purpose. You have not shown that you are not operated to serve as an instrument to generate public funding for B, H, C and B's for-profit beauty salon business resulting in inurement and/or impermissible private benefit. As provided in section 1.501(c)(3)-1(d)(1)(ii) of the regulations, you have not demonstrated that you met the burden of proof that you are exclusively operated for exempt purposes under section 501(c)(3) of the Code.

Conclusion:

In summary, you have not satisfied the organizational and operational requirements of the Code and regulations to be recognized as exempt under section 501(c)(3) of the Code. You do not meet the organizational test for recognition of tax exemption under section 501(c)(3) of the Code. The administrative record demonstrates that you operate for a substantial non-exempt commercial purpose rather than a charitable purpose in contravention of section 501(c)(3) of the Code. In addition, you have not established that your income will not inure to and/or serve the impermissible private benefit of your board member, B, your officer, C and your fundraising consultant, H. Furthermore, you have not met your burden of proof that you are formed exclusively for an exempt purpose under section 501(c)(3) of the Code.

Consideration was given to whether you qualify for exemption under other subsections of section 501(c) of the Code. However, based on the information that you have submitted, we cannot find that you are entitled to exempt status under section 501(c) of the Code.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination. If your statement

does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in Publication 892; *Exempt Organization Appeal Procedures for Unagreed Issues*.

Types of information that should be included in your appeal can be found on page 2 of Publication 892. These items include:

1. The organization's name, address, and employer identification number;
2. A statement that the organization wants to appeal the determination;
3. The date and symbols on the determination letter;
4. A statement of facts supporting the organization's position in any contested factual issue;
5. A statement outlining the law or other authority the organization is relying on; and
6. A statement as to whether a hearing is desired.

The statement of facts (item 4) must be declared true under penalties of perjury. This may be done by adding to the appeal the following signed declaration:

"Under penalties of perjury, I declare that I have examined the statement of facts presented in this appeal and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete."

Your appeal will be considered incomplete without this statement.

If an organization's representative submits the appeal, a substitute declaration must be included stating that the representative prepared the appeal and accompanying documents; and whether the representative knows personally that the statements of facts contained in the appeal and accompanying documents are true and correct.

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. If you want representation during the appeal process, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. You can find more information about representation in Publication 947, *Practice before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to appeal as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848, and any supporting documents to the applicable address:

Mail to:

Deliver to:

Attn:

Attn:

You may fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert Choi
Director, Exempt Organizations
Rulings & Agreements

Enclosures: Publication 892